No. 18,723

In the United States Court of Appeals for the Ninth Circuit

JOHN D. and JANICE L. EDWARDS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition From the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and the opinion of the Tax Court (Doc. No. 14)[1] are reported at 39 T.C. No. 8.

JURISDICTION

This appeal involves a deficiency in federal income for the year 1955. After being served with a notice of deficiency, taxpayers seasonably filed a petition

[1] Doc. No. references are to the documents as enumerated in the index to the record on review, as Certified to this Court by the Clerk of the Tax Court of the United States.

with the Tax Court seeking to resist the assessment of additional income taxes for the year 1955. (Doc. No. 2.) The decision of the Tax Court, adverse to the taxpayers, was entered on December 10, 1962 (Doc. No. 1) and the case was brought to this Court by their petition for review filed on April 4, 1963 (Doc. No. 17). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court correctly decided that a tax which should have been, but in fact was not, withheld from payments made to an employee may *not* be credited by that employee against his reportable tax for the subject year.

2. Whether the Tax Court correctly decided that for purposes of determining a taxpayer's sick pay exclusion only those days for which he is actually paid pursuant to a wage continuation plan, and not the entire period over which he is absent, are to be considered in computing the exclusion allowable under Section 105 of the 1954 Internal Revenue Code.[2]

STATUTES AND REGULATIONS INVOLVED

The statutes and Regulations involved are set out in the Appendix, *infra*.

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[2] All section references herein are to the 1954 Internal Revenue Code.

STATEMENT

In 1955 the taxpayer[3] received $13,027.21 from his employer in settlement of two judgments totalling $15,155. These judgments resulted from lawsuits brought to collect bonuses allegedly owed him. (Doc. No. 14, pp. 3-5.) In computing the settlement no amounts were excluded for withholding taxes and there is no evidence in the record to indicate that his employer or the taxpayer ever specifically contemplated the retention of any amounts for the purpose of this tax. (Doc. No. 14, pp. 6, 9.) Taxpayer's employer did not, in fact, withhold any amount for withholding taxes nor did it pay any amount to the Internal Revenue Service on account of those taxes. Taxpayer received no W-2 Form from his employer for the year 1955, nor did he receive any other notice indicating that the company had withheld any amount for taxes from the settlement. (Doc. No. 14, p. 6.)

The taxpayer filed a return for the year 1955 reporting as income the full amount of the settlement, less attorney's fees and costs. He later amended his return so as to report as income the full amount of the judgments, and took as a tax credit an amount ($2,604.30) "which he stated was his computation of the tax 'which should have been paid' by the company." (Doc. No. 14, p. 6.)

The Commissioner refused to accept the amount claimed as a credit on the amended return, asserted

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[3] References to "taxpayer" are to Petitioner John Edwards.

a deficiency, and prevailed in the Tax Court action in which that deficiency was contested.

In 1955 the taxpayer was hospitalized in connection with his work from November 30 through December 23. He was unable to work for a period of five weeks. Prior to and following his absence from employment he had worked a six-day week. (Doc. No. 14, p. 6.) Pursuant to a wage continuation plan he was paid $134 for three days of his hospitalization, one day for each of the two months he had previously worked and for the first day of the injury. On his tax return for 1955, taxpayer claimed an exclusion of $96, which was partially disallowed. (Doc. No. 14, pp. 7-8.) The taxpayer brought this issue before the Tax Court, which held that he was entitled to exclude $50 of the $134, i.e., one-half of the $100 maximum weekly exclusion allowable under Section 105(d) of the 1954 Internal Revenue Code. (Doc. No. 14, p. 12.)

Taxpayer appears to have subsequently obtained a judgment for pay for the full amount of time he was absent from work, and now urges that he is entitled to the maximum exclusion of $100 per week for the period November 30 to December 31, 1955. (Br. 3.) (There is nothing in the record or taxpayer's brief to indicate the dollar amount of the judgment awarded him, but presumably it exceeded $500.) A portion of the judgment is quoted in taxpayer's brief (Br. 2-3) and recites that payments for the period not worked were owing the taxpayer as a result of the "custom and practice" of the industry.

SUMMARY OF ARGUMENT

I. Section 31(a)(1) of the 1954 Internal Revenue Code and the Treasury Regulations promulgated thereunder, provide that a tax credit is to be given a taxpayer for that tax *actually* withheld from his wages by his employer. Where no tax has been withheld, the taxpayer can claim no credit. Although the Government may seek to collect the tax from an employer who should have, but failed to, withhold it this remedy is not exclusive and surely does not preclude collection of the tax from the income-recipient.

II. When an employee is awarded sick pay under a wage continuation plan, the amount paid him cannot be allocated over the entire period for which he was absent for purposes of computing the allowable weekly exclusion available to him under Section 105(d) of the 1954 Internal Revenue Code. The sick pay is to be imputed only to the days for which the taxpayer was actually reimbursed. In this case the taxpayer was paid for three days, his work week was six days, and therefore, he is entitled to one-half of the maximum weekly exclusion ($100) allowable under Section 105(d) of the 1954 Internal Revenue Code.

ARGUMENT

I

The Tax Court Was Correct In Deciding That the Taxpayer Should Not Be Allowed a Credit for Withholding Tax for the Year 1955, There Being No Evidence That Such Tax Was In Fact Withheld By His Employer

Taxpayer had been employed by Arthur Fralick during 1953 as a steel construction superintendent

on a construction project. He earned but was not paid a contingent bonus of $1,000. In 1954 he was promised a contingent bonus in connection with another project of Fralick's but was fired before he could collect it. Edwards brought a successful suit to recover those bonuses and was awarded judgments in the total amount of $15,155. (Doc. No. 14, p. 3.) Fralick considered appealing the lower court decision, but because of the necessity to clear up outstanding litigation he agreed to settle the judgments for $13,027.21, less attorney's fees, costs, and a judgment owed Fralick by the taxpayer. (Doc. No. 14, p. 4.) The taxpayer received the agreed-upon amount in full satisfaction of the judgments. At no time did the parties negotiate or include in their settlement agreement any figure reflecting the withholding taxes or the liability therefor. (Doc. No. 14, p. 4.) The Tax Court found, as a fact, that "The company did not withhold any amount on account of Federal income taxes from the sum paid in settlement of the litigation." (Doc. No. 14, p. 6.) Taxpayer in his brief (Br. 9) acknowledges that he was informed by the Internal Revenue Service that no withholding tax was paid by his employer.

Whether Fralick should have withheld an amount for tax purposes is immaterial to this controversy.[4] The important and controlling fact is that no tax

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[4] The Internal Revenue Service has ruled that lump-sum payments to an employee made because of the cancellation of an employment contract are not subject to withholding. Rev. Rul. 55-520, 1955-2 Cum. Bull. 393; Rev. Rul. 58-301, 1958-1 Cum. Bull. 23; see also, Rev. Rul. 59-227, 1959-2 Cum. Bull. 13.

was withheld by Fralick. Section 31(a)(1) (Appendix, *infra*) provides that a credit shall be given to a taxpayer for "The amount *withheld* under Section 3402 as tax on the wages of any individual," thus restricting the tax credit to amounts actually retained by the employer.[5] Where there clearly has been no withholding, as in this case, no credit can be claimed for it.

The principal purpose of the withholding tax system is to simplify the administrative problems of tax collection.[6] The plan was hardly designed to relieve

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[5] See Treasury Regulations on Income Tax (1954 Code), Sec. 1.31-1(a) Appendix, *infra*). "If the tax has *actually* been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer." (Emphasis supplied.) Cf., *Basila* v. *Commissioner*, 36 T.C. 111, in which an employee sought to take a withholding credit for the year 1952, although his employer did not actually pay over the withholding tax until 1953. The Tax Court allowed the 1952 credit, on the finding that the tax was actually withheld in that year.

As carefully noted by the court below (Doc. No. 14, p. 9) in distinguishing this case from *Basila*, "The evidence in this case clearly shows, however, that the employer did not comply with the withholding provisions but paid to petitioner the entire amount agreed to by the parties in full satisfaction of the judgment."

[6] See H. Rep. No. 2333, 77th Cong., 2d Sess., p. 14 (1942-2 Cum. Bull. 372, 385), on the Revenue Act of 1942, c. 619, 56 Stat. 798. ("Under this system many recipients of income who would not otherwise pay income tax either by reason of neglect to file returns or not being employed in the year following the year when income is derived, or for other reasons, will be brought under the income tax.")

It was also thought that the withholding system would ease the burden on taxpayers by "enabling him to meet his tax payments with a minimum of strain." *Ibid.*

taxpayers of their liability for the tax on their own income. Where the agent for tax collection (i.e., the employer) has been remiss in his responsibility, the taxpayer cannot be heard to disclaim his own liability. To hold otherwise would produce administrative headache, inequity, and, possibly, collusion between financially-precarious employers and their employees.

II

The Tax Court Was Correct In Finding That the Taxpayer Could Exclude As Sick Pay One-Half of the Maximum Weekly Exclusion Provided Under Section 105(d) Since the Taxpayer Was Paid for But Three Days of Absence and Normally Worked a Six-Day Week

The taxpayer was injured and hospitalized on November 30, 1955. He was released from the hospital on December 23, 1955, and was, in all, absent from work for a period of five weeks. (Doc. No. 14, p. 6.) He was paid, pursuant to a wage continuation plan of his employer, $134 for three days of absence, attributable to the day of the injury and the two days thereafter. (Doc. No. 14, p. 7.) The taxpayer claimed that the amount paid him should be spread over the entire term of his absence and should not be allocated only to the three days for which he was, in fact, paid. The Tax Court rejected this contention, properly limiting its exclusion to $50 which represented one-half of the maximum weekly exclusion ($100) allowable under Section 105(d) (Appendix, *infra*).

That section clearly dictates that sick pay must be included as gross income to the extent that the

payments exceed a *weekly rate* of $100. In computing the weekly rate of pay, and the allowable exclusion therefrom, the Regulations (Appendix, *infra*) specifically provide for cases like this one where an employee receives payments under a wage continuation plan for "less than a full pay period":

> Sec. 1.105-4. *Wage continuation plans.*
>
> * * * *
>
> (d) *Exclusion not applicable to the extent that amounts exceed a weekly rate of $100—In general.* Amounts received under a wage continuation plan which are not excludable from gross income as being attributable to contributions of the employee (see § 1.105-1) must be included in gross income under section 105(d) to the extent that the weekly rate of such amounts exceeds $100. Thus, an employee, who receives $50 under his employer's wage continuation plan on account of his being absent from work for two days due to a personal injury, cannot exclude the entire $50 under section 105 (d) if the weekly rate of such benefits exceeds $100. If an employee receives payments under a wage continuation plan for less than a full pay period, the excludability of such payments shall be determined under subparagraph (2) of this paragraph. * * *
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> * * * *
>
> (2) *Daily exclusion.* If an employee receives payments under a wage continuation plan for less than a full pay period, the extent to which such benefits are excludable under section 105 (d) shall be determined by computing the daily

> rate of the benefits which can be excluded under section 105(d). Such daily rate is determined by dividing the weekly rate at which wage continuation payments are excludable ($100) by the number of work days in a normal work week.
> * * *
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> * * * *
>
> (26 C.F.R., Sec. 1.105-4.)

Under the aforesaid formula, the excludable daily rate of sick pay was $16.67 ($100 divided by 6), and since taxpayer was paid for three days his allowable exclusion was $50, as the Tax Court so found. "Stated another way, petitioner was paid for one-half of his normal working week. He would, therefore, be allowed to exclude one-half of the $100 weekly rate limitation or $50." (Doc. No. 14, p. 12.)

There is nothing in the Code or the Regulations which suggests that sick pay may be spread over a period different from that for which it was actually paid. If an employee were paid $500 for the first week of an absence and nothing thereafter, and he was absent from work for a month, only $100 would be excludable. The terms of the wage continuation plan are controlling and if that plan "accelerates" income, the exclusion privilege extended under Section 105(d) cannot be stretched or reinterpreted to permit the spreading of that income, as taxpayer urged the lower court to hold.

The taxpayer now claims that a Washington State Court judgment has awarded him an amount of sick pay, apparently in excess of $500, for the period of absence. However, that amount is includible in *pres-*

ent income, subject to a possible credit under the provisions of Section 1303.[7] Furthermore, it is doubtful whether taxpayer would be entitled to an exclusion under Section 105(d) since payments, to qualify, must be made pursuant to a wage continuation plan.[8]

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[7] SEC. 1303. INCOME FROM BACK PAY.

(a) *Limitation on Tax.*—If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 per cent of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under regulations prescribed by the secretary or his delegate.

* * * *

(26 U.S.C. 1958 ed., Sec. 1303.)

[8] Treasury Regulations on Income Tax (1954 Code):

Sec. 1.105-4 *Wage continuation plans.*

(a) *In general.*—* * *

(2) (i) Section 105(d) is applicable only if the wages or payments in lieu of wages are paid pursuant to a wage continuation plan. The term "wage continuation plan" means an accident or health plan, as defined in § 1.105-5, * * *.

* * * *

(26 C.F.R., Sec. 1.105-4.)

Sec. 1.105-5 *Accident and health plans.*

* * * An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will

However, that issue is not properly before this Court, which has only to decide whether, as we urge, the Tax Court correctly permitted the exclusion of $50 of the $134 which the taxpayer actually received in 1955 as sick pay for three days of absence.

CONCLUSION

For the reasons herein stated, the judgment of the Tax Court below should be affirmed.

Respectfully submitted,

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AUGUST, 1963.

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be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. * * *

(26 C.F.R., Sec. 1.105-5.)

Certificate

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ..... day of ....., 1963.

Robert J. Golten

APPENDIX

Internal Revenue Code of 1954:

SEC. 31. TAX WITHHELD ON WAGES.

(a) *Wage Withholding for Income Tax Purposes.*—

(1) *In general.*—The amount withheld under section 3402 as tax on the wages of any individuall shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

* * * *

(26 U. S. C. 1958 ed., Sec. 31.)

SEC. 105. AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS.

* * * *

(d) *Wage Continuation Plans.*—Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work to account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. In the case of a period during which the employee is absent from work on account of sickness, the preceding sentence shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the

method of determining the weekly rate at which such amounts are paid.

* * * *

(26 U.S.C. 1958 ed., Sec. 105.)

SEC. 3402. [As amended by Sec. 2(a) of the Act of August 9, 1955, c. 666, 69 Stat. 605] INCOME TAX COLLECTED AT SOURCE.

(a) *Requirement of Withholding.*—Every employer making payment of wages shall deduct and withhold upon such wages (except as provided in subsection (j)) a tax equal to 18 percent of the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in subsection (b) (1).

* * * *

(d) *Tax Paid by Recipient.*—If the employer, in violation of the provisions of this chapter, fails to deduct and withhold the tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer; but this subsection shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

* * * *

(26 U. S. C. 1958 ed., Sec. 3402.)

SEC. 3403. LIABILITY FOR TAX.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment.

(26 U. S. C. 1958 ed., Sec., 3403.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.31-1 *Credit for tax withheld on wages.*

(a) The tax deducted and withheld at the source upon wages under chapter 24 of the Internal Revenue Code of 1954 (or in the case of amounts withheld in 1954, under subchapter D, chapter 9 of the Internal Revenue Code of 1939) is allowable as a credit against the tax imposed by subtitle A of the Internal Revenue Code of 1954, upon the recipient of the income. If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer. For the purpose of the credit, the recipient of the income is the person subject to tax imposed under subtitle A upon the wages from which the tax was withheld. For instance, if a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes make separate returns, each reporting for income tax purposes one-half of the wages received by the husband, each spouse is entitled to one-half of the credit allowable for the tax withheld at source with respect to such wages.

* * * *

(26 C.F.R., Sec. 1.31-1.)

Sec. 1.105-4. *Wage continuation plans.*

* * * *

(d) *Exclusion not applicable to the extent that amounts exceed a weekly rate of $100*—(1) *In general.*—Amounts received under a wage continuation plan which are not excludi-

ble from gross income as being attributable to contributions of the employee (see § 1.105-1) must be included in gross income under section 105(d) to the extent that the weekly rate of such amounts exceeds $100. Thus, an employee, who receives $50 under his employer's wage continuation plan on account of his being absent from work two days due to a personal injury, cannot exclude the entire $50 under section 105 (d) if the weekly rate of such benefits exceeds $100. If an employee receives payments under a wage continuation plan for less than a full pay period, the excludibility of such payments shall be determined under subparagraph (2) of this paragraph. * * *

* * * *

(2) *Daily exclusion.* If an employee receives payments under a wage continuation plan for less than a full pay period, the extent to which such benefits are excludable under section 105 (d) shall be determined by computing the daily rate of the benefits which can be excluded under section 105(d). Such daily rate is determined by dividing the weekly rate at which wage continuation payments are excludable ($100) by the number of work days in a normal work week. * * *

* * * *

(26 C.F.R., Sec. 1.105-4.)

Treasury Regulations on Employment Tax (1954 Code):

Sec. 31.3402(d)-1 *Failure to withhold.*

If the employer in violation of the provisions of section 3402 fails to deduct and withhold the

tax, and thereafter the income tax against which the tax under section 3402 may be credited is paid, the tax under section 3402 shall not be collected from the employer. Such payment does not, however, operate to relieve the employer from liability for penalties or additions to the tax applicable in respect of such failure to deduct and withhold. The employer will not be relieved of his liability for payment of the tax required to be withheld unless he can show that the tax against which the tax under section 3402 may be credited has been paid. See § 31.3403-1, relating to liability for tax.

(26 C.F.R., Sec. 31.3402(d)-1.)

Sec. 31.3403-1 *Liability for tax.*

Every employer required to deduct and withhold the tax under section 3402 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee by the employer. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. See, however, § 31.3402(d)-1. The employer is relieved of liability to any other person for the amount of any such tax withheld and paid to the district director or deposited with a duly designated depositary of the United States.

(26 C.F.R., Sec. 31.3403-1.)

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